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In The

Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-1894

GRACE CAPPUCCILLI, ET AL.,

Petitioners,

— v. —

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITIONERS' REPLY TO RESPONDENT'S MEMORANDUM IN OPPOSITION

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1. Respondent argues that *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394, is distinguishable because during the years 1970, 1971 and 1972 there was no legal prohibition by Stonehedge to pay the (imputed) interest to CCP. Respondent's reasoning is that had CCP (in 1962-the time of the installment sale) charged interest, then Stonehedge could have legally paid it during the years in issue. (R. 3,4)

First, there was no requirement under the federal income tax laws to charge interest (on related party transactions) prior to 1968. (Pet. 9) Secondly, the question involved is *whether during the years 1970, 1971 and 1972, Stonehedge was legally prohibited from paying interest to CCP*; and the answer is yes, according to the Bankruptcy Court's decision. (Pet. 6) Accordingly, the holding of *First Security Bank* should apply.

2. As to the violation of Paduano's constitutional rights, Petitioners in their brief to the Second Circuit argued that Mr. Paduano derived no economic benefit during 1970, 1971 and 1972 on interest free loans from CCP to Stonehedge, because Mr. Paduano had relinquished his interest in Stonehedge during 1969. Petitioners stated that on the contrary, as a creditor, Mr. Paduano suffered financial loss due to the failure by Stonehedge to pay principal payments timely and by the failure to pay interest. (Appellants' Brief to Second Circuit pp. 22-24)

In any event, this Court has held that in the interest of Justice a new issue may be considered on appeal. *Hormel* v. *Helvering*, 312 U.S. 552.

3. *The Commissioner apparently rejects the Second Circuit's "double deduction" theory because he argues that:*

> "The partners in CCP perhaps used the assets of CCP to make a contribution to Stonehedge in the amount of interest not charged; and may be entitled to increase their basis in the Stonehedge stock to reflect this contribution".

If the Commissioner supported the "double deduction" theory why would it be necessary to give "additional" tax relief to Petitioners in the form of an increase in stock basis.

Further, if Respondent is permitted to assert the capital contribution theory then Petitioners could also argue that the entire loans (and installment note) were not in fact loans but capital contributions in which case no interest allocation would apply. This was one of the theories advanced by the taxpayers in the *Forman* case and the Second Circuit Court rejected it totally, stating: "there is no evidence in the record that the

taxpayers received additional stock in Midtown for these alleged capital contributions", *B. Forman Co.* v. *Commissioner*, 453 F2d, 1144, 1156 cert. denied, 407 U.S. 934; nor is there evidence in the instant case that Petitioners received additional stock in consideration for the imputed interest which they did not receive.

Finally, the government's "capital contribution"(1) theory fails to explain how a former shareholder like Paduano could receive an increase in his stock basis some ten or more years (1969) after divesting himself of his interest in the corporation. It is clear that Paduano's ability to recognize an increase in his stock basis would have been foreclosed three years after filing his 1969 tax return (the statute of limitations for filing amended returns). Also, the government's theory would unfairly discriminate against shareholders who have sold their stock and against donees who have received such stock from donors with an obviously reduced basis. Section 1015 IRC.

Respondent argues that Petitioners are not entitled to a bad debt loss or business loss deduction on the theory that Stonehedge had no obligation to pay the interest - "there was no debt and no loss". (R. 5) The fact that Petitioners paid federal income taxes on $325,718.00 of fictional income plus interest on said taxes from 1967 cannot be denied (New York State income taxes would also have to be paid, since New York applies federal adjustments to its taxes). The *total loss to Petitioners* of federal and state income taxes plus accrued interest from 1967 would approximate $243,000.00.(2) Since this loss resulted from a tax asserted by the Commissioner on phantom income, Petitioners' relief would be in the form of a loss deduction (phantom or otherwise) to recover all or part of said tax payments.

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(1) The capital contribution theory was argued by the Commissioner in both the United States Tax Court and the Second Circuit Court; neither Court adopted this theory.

(2) See affidavit of Paul Kinlry, CPA; Appendix.

The Commissioner also argues that the granting of a deduction would "serve to nullify the Commissioner's allocation". (R. 5) But the tax law allows deductions for bad debts and business losses, and Petitioners are asking for no more than that which is allowed to non-related parties in similar circumstances. (Pet. 17)

To sum up, it should be noted that the Second Circuit Court relied upon a "double deduction" theory; a theory which was not argued by the Commissioner either in the Tax Court or the Second Circuit Court, and which was not even mentioned by the Commissioner in his Memorandum in Opposition. *Therefore, it appears that the Commissioner agrees with the Petitioners that the "double deduction" theory of the Second Circuit is incorrect as a matter of law.*

4. As to the retroactive application issue (R. 5, footnote 7) the cases cited by the Commissioner preceded *U.S. v. Darusmont*, 449 U.S. 292 which apparently is the latest authority on that question. That Court stated:

> Usually the "retroactive" feature has application only to that portion of the current calendar year preceding the date of enactment, but each of the Revenue Acts of 1918 and 1926 was applicable to an entire calendar year that had expired preceding enactment. This "retroactive" application apparently has been confined to short and limited periods required by the practicalities of producing national legislation. We may safely say that it is a customary congressional practice.
>
> [No per se violation]
>
> The Court consistently has held that the application of an income tax statute to the entire calendar year in which enactment took place does not per se violate the Due Process Clause of the Fifth Amendment. (Citations omitted)

5. Concerning the capital gain argument (R. 6, unnumbered footnote), the Commissioner argues that "the record demonstrates that the gain was in fact the profits and losses arising from the everyday operation of a business". However, the record apparently was not that clear to the Tax Court

Judge, the trier of facts, because he had to rely on a joint venture theory (a theory not adopted by the Second Circuit) in order to find that Petitioners were developers.

It is therefore submitted that the petition for a writ of certiorari should be granted.

VICTOR CHINI, ESQ.
Attorney for Petitioners

Stanley Germain, Jr., Esq.,
Of Counsel.

STATE OF NEW YORK)
COUNTY OF ONONDAGA) SS:

PAUL KINIRY, being duly sworn deposes and states:

1. That he is a certified public accountant and associated with Kiniry & Misner, P. C., Certified Public Accountants, with offices at 815 State Tower Building, Syracuse, New York.

2. That he made a computation for the partners of CCP of the federal income taxes and interest from 1967 paid to the Internal Revenue Service on the imputed interest income issue for the years 1967 through 1972 which totalled $218,000.00 and which amount was paid before June 1982.

3. That he made a computation for the partners of CCP of the estimated taxes and interest from 1967 due to New York State for the years 1967 through 1972 which totalled approximately $25,000.00.

4. That as of this date the amounts due New York State have not been paid.

5. That the total amount of all federal and New York State taxes and accrued interest from 1967 on the imputed interest income allocated under Section 482 for the years 1967 through 1972 is approximately $243,000.00.

Paul Kiniry
Paul Kiniry

Sworn to before me this
28th day of June, 1982.

Jeannine Tartaro
Notary Public

JEANNINE TARTARO
Notary Public in the State of New York
Qualified in Onondaga Co. No. 4641236
My Commission Expires March 30, 19 84